**Remarks by Under Secretary Cynthia A. Glassman**
**A Look Back: The Impact of Sarbanes-Oxley**

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I appreciate the invitation to participate in the Center for Economic Policy Studies' Spring Symposium to discuss the impacts of the Sarbanes-Oxley Act on U.S. businesses and financial markets. I was a Commissioner at the Securities and Exchange Commission in 2002 when the Congress passed and the President signed the Act, and I was there when the SEC drafted, sought comments on, and approved the regulations implementing Sarbanes-Oxley.

I want to say unequivocally at the outset that U.S. capital markets – before and after Sarbanes-Oxley, and despite the many legitimate complaints about the implementation of Sarbanes-Oxley – have been and remain the best in the world. However, there is room for improvement, particularly with respect to SOX. As I said many times when I was an SEC Commissioner, the law itself is not the problem. It is the implementation of the law, especially Section 404, that is the problem. I believe that even more, from my new perspective at Commerce.

The Securities and Exchange Commission's mission is "to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation."[1] The SEC implements its mission by requiring public companies to report essential financial information that investors need to make sound decisions on whether to buy, hold, or sell securities. It is the potential disconnect between the interests of investors in learning what they need to know about a company and the interests of managers in divulging financial information that is the nexus of SEC rule-making and enforcement. At the SEC, I met frequently with capital market participants, including investors, to hear their issues and learn from their insights.

In my current role as Under Secretary of Commerce for Economic Affairs, my institutional focus is somewhat different. The mission of the Commerce Department is "to foster, promote, and develop the foreign and domestic commerce" of the United States.[2] In other words, the Commerce Department is concerned with the overall health of private sector companies and the economy in general.

Therefore, my remarks will focus on the impact of Sarbanes-Oxley on companies and on the economy. But first I will frame my comments on the impact of Sarbanes-Oxley by saying a little bit about my philosophy of regulation.

As an SEC Commissioner and an economist, I tried to inject more economic rigor and more awareness of empirical work into the Commission's rule-making and enforcement initiatives, and I tried to instill more of a cost-benefit mindset in the Commission's culture. Recently, such changes are also being pushed by the courts. As a Commissioner, I asked several questions about each proposal for new or amended rules that came across my desk:

- *What objectives are we trying to accomplish with this rule?*
- *Will the rule, as enforced, meet our objectives?*
- *Does the rule go far enough – or too far?*
- *Does the rule foster compliance with the spirit as well as the letter of its provisions?*
- *Does the rule make sense? Are there likely to be unintended consequences? Are the benefits commensurate with the costs?*
- *Does the rule allow entities choice in implementation? Or does the rule take a one-size-fits-all approach to regulation?*
- *Does the rule create unrealistic expectations?*

And these are also the questions that inform my review of Sarbanes-Oxley.

There were five major goals of Sarbanes-Oxley that were designed to restore investor confidence after corporate scandals early in this decade.

**(1)** **Restoring confidence in the accounting profession.** Sarbanes-Oxley attempted to restore confidence in the accounting profession by creating the Public Company Accounting Oversight Board (PCAOB) and by limiting potential conflicts of interest at accounting firms. The PCAOB was created to give the SEC greater control over the setting of public company auditing standards than was the case when the accounting industry regulated itself.

**(2)** **Improving the "tone at the top" of public companies.** One of the other goals of Sarbanes-Oxley was to foster an ethical corporate culture and reduce conflicts of interest. Sarbanes-Oxley required officers to certify to the accuracy and completeness of its companies' financial statements. It also required all members of a public company's audit committee to be independent of management and required that procedures be established by which employees and gatekeepers can safely report concerns about the integrity of financial reports.

**(3)** **Improving corporate disclosure and financial reporting.** Sarbanes-Oxley requires companies to disclose on a "rapid and current basis" information concerning material changes in the financial condition or operation of the company as determined by the SEC for the protection of investors and in the public interest. The SEC has promulgated rules on the use of non-GAAP financial measures, as well as the requirement that the SEC review the periodic reports of public companies no less frequently than once every three years. And, importantly, it implemented the disclosure requirements on internal controls over financial reporting of the infamous Section 404.

**(4) Improving the performance of gatekeepers.** "Gatekeepers" are professionals -- auditors, attorneys, credit rating agencies, and securities analysts -- who are in a position to protect investors by deterring companies from engaging in possibly illegal or potentially fraudulent financial activities. The SEC adopted a number of rules related to gatekeepers.

**(5) Enhancing enforcement tools to guard against corporate fraud.** The SEC now has the ability to establish "Fair Funds" in enforcement actions so that civil penalties levied against companies can be returned to harmed shareholders (rather than the Treasury), in addition to any ordered disgorgement of illicit profits. Maximum criminal and civil penalties for violations of securities laws were increased. Sarbanes-Oxley also increased the SEC's resources for enforcing securities laws, and the Justice Department beefed up its enforcement of criminal provisions of such laws.

Today I have been asked to look back and discuss the impact of Sarbanes-Oxley. I will do that by assessing how effective the Act has been in addressing each of these goals. But first, let me note some difficulties in making such assessments. It is difficult to identify any "natural experiments" that allow researchers to test whether the Act has added value to firms (and thereby their shareholders) required to comply with the Act's provisions compared with a control group of otherwise similar firms that were not required to comply. There were major, unique circumstances surrounding the run-up to the Act – in particular, the stock market bubble of the late 1990s -- that make it difficult to parse the impact of the Act and the impact of other coinciding circumstances. At the same time, there were other regulatory actions within the U.S. and elsewhere, which may confound efforts to measure the effects of Sarbanes-Oxley. For instance, the SEC had rules in the works prior to or concurrently with the passage of Sarbanes-Oxley. It is hard to pinpoint the exact timing of the Act and its regulations and consequent changes in corporate and investor behavior, some of which may have occurred before, during, after, or regardless of the passage of SOX. All these factors make it difficult to differentiate or separate out the effects of Sarbanes-Oxley.

In addition to assessing how well the five goals of Sarbanes-Oxley are being met, I would like to comment on two additional factors: the unintended consequences, both positive and negative, of Sarbanes-Oxley implementation and the effects of the law on international financial markets.

Here is my assessment on how well these objectives been met.

<u>Confidence in the accounting profession.</u> To some extent, confidence seems to have been restored. It appears that Sarbanes-Oxley has improved the financial reporting process by strengthening independence. For example, Sarbanes-Oxley's call for independent funding of FASB has removed it from some of the political pressures that audit clients can bring to bear on the standard-setting process. And Sarbanes-Oxley's limitations on auditors' provision of non-auditing services has strengthened the perception of independence. However, serious concerns remain about the cost of audit services, concentration of the accounting industry, auditor liability, and complexity of accounting rules.

Tone at the top. Tone at the top is hard to measure, but there is anecdotal evidence that there are fewer so-called "imperial" CEOs. Also, I have heard that corporate directors, especially audit committee members, are spending significantly more time on their Board duties. Whether that is due to Sarbanes-Oxley, SEC enforcement actions, or jail sentences, however, is not clear.

Financial disclosure and reporting. Empirical evidence suggests that the market responded positively to the SEC's first-ever requirement – issued in the wake of the WorldCom scandal and, shortly thereafter, incorporated into Sarbanes-Oxley – for financial report certification by CEOs and CFOs. In addition, and not surprising, evidence suggests that strong internal controls are associated with better quality financials. Sarbanes-Oxley may be credited with increasing the quality of financial statements; restatements were down 20% in 2006 for public companies with revenues of $75 million or more – but there may be other explanations. As I said last year, when I was still at the Commission, about the restatements in 2005:

> "I do not believe that all of these financial restatements are due to Section 404. First, of the 1,195 companies that restated in 2005, less than half were accelerated filers, which means that a majority of the restatements were by companies that did not have to comply with Section 404. In addition, many of these restatements resulted from differing views on applying complex accounting rules, such as those related to lease accounting, hedging transactions and stock options. Further, some of these restatements could have been related not to Section 404, but to the increased financial statement review by Commission staff resulting from Section 408…Finally, even for those restatements that resulted from Section 404, it would be useful to know if the restatements were the result of management's assessment or auditor review."[3]

But Sarbanes-Oxley implementation is a work in progress in this regard. As I have said repeatedly, the implementation of Section 404, along with PCAOB's AS2 requirement, has gone off track. Auditors seem to have interpreted PCAOB's guidance to focus on problems with a "more than remote chance" of resulting in material changes to financial statements as meaning "any chance at all." As I have said since AS2 was developed, we need to keep the focus of 404 on what it was meant to be, i.e., a top-down, entity-wide risk-based management perspective as opposed to a bottom-up, "check the box" control-by-control perspective. I believe that the SEC's new proposed guidelines on Management's Report on Internal Control Over Financial Reporting[4] and PCAOB's proposed AS5 audit standards are moving in the right direction.

Performance of gatekeepers. There is not much empirical work available on the costs versus benefits of the gatekeeper provisions of the Act. I would note that as of 2005, less than three percent of issuers had availed themselves of the safe harbor protections afforded by Qualified Legal Compliance Committees, but perhaps just the existence of these new structures serves as deterrents to wrongdoers.

Enhanced enforcement tools. In the four fiscal years since Sarbanes-Oxley was enacted, the SEC has authorized a cumulative total of $5.15 billion in disgorgement and penalties of which $4.33 billion has been collected and placed in the Fair Funds program for return to shareholders, but the process has proved cumbersome and not as easy to implement as it may have first appeared. Further, although hundreds of employees have sought protection under the whistleblower provisions of Sarbanes-Oxley, most of those cases have been dismissed or withdrawn.

Unintended consequences. Some researchers point to evidence that improved internal controls have led to cost savings. Other researchers have hypothesized and presented empirical evidence that Sarbanes-Oxley has distracted CEOs and made them more risk averse. Another unintended consequence is that many entities not covered by Sarbanes-Oxley – privately held firms, non-profit organizations, and government agencies – are increasingly adopting some of its provisions at the behest of their auditors, which may or may not be a good thing, depending, of course, on the benefits from any improvements in the quality of their internal controls and their costs of implementation. Also a concern raised in a number of conversations I have had with CEOs in the past several months as part of my activities in support of Secretary of Commerce Gutierrez's Measuring Innovation in the 21st Century Economy Advisory Committee is that Sarbanes-Oxley creates impediments to innovation by chilling risk taking.

International financial markets. Much has been made of the recent decline in U.S. stock exchanges' share of the world IPO market. But this decline was occurring before Sarbanes-Oxley was enacted, and is at least in part a consequence of strengthening stock exchanges around the world. Studies suggesting it is costlier to launch an IPO in the U.S. than in Europe do not show any widening of the cost gap after Sarbanes-Oxley. Further, reportedly, only a small minority of survey respondents among U.S. firms that chose to list on London's AIM exchange cited Sarbanes-Oxley as a reason, and others reported that they were already in compliance (or planning to comply) with Sarbanes-Oxley anyway. On the other hand, in the last couple of weeks, several firms – most notably British Airways – have decided to take advantage of new SEC rules that allow foreign firms with less than five percent of their trading volume in the U.S. to delist their shares from the major U.S. exchanges (under the old rules, they could delist only if they had fewer than 300 U.S. shareholders). British Airways says that delisting should save about $20 million annually.

There are any number of reasons that companies might list on one exchange or another. Sarbanes-Oxley could be one of those reasons but it is not easy to discern which motive carries more or less weight in the decisions as to whether to list a company here or abroad or not at all.

What is Sarbanes-Oxley's overall report card? Given the short time-frame since Sarbanes-Oxley was enacted and the implementing regulations put into place, it is difficult to make a definitive statement about whether the benefits of the law exceed its costs; there is no consensus in the literature, and findings are all over the map. Overall estimates based on investor expectations in the period during which Sarbanes-Oxley was debated and regulations formulated range from a net *reduction* in market valuations of $1.4 trillion after Sarbanes-Oxley was enacted, to a net *increase* in market valuations of $600 billion from just the enhanced disclosure provisions of the Act. There appear to be some benefits, but they are diffuse and hard to measure, as is usually the case in government regulation. Direct costs are high, especially those related to 404. Notably, the significantly increased audit fees have not decreased as much as expected in the second year of 404 implementation for large listed companies. Indirect costs in the form of CEO and Board distraction and reduced willingness to take the risks needed for innovation may be at least as high as direct costs, but also difficult to measure.

One thing that particularly concerns me is the focus on improving Section 404 for small businesses, not all businesses. The focus should be on appropriate implementation for all companies. There seems to be an acceptance at large companies that Section 404 is just another cost of doing business. However, we are talking about millions of dollars per company that are not available for other initiatives that could increase returns to shareholders and keep our companies competitive. I have heard over and over again that big business can live with the cost, but just because they can does not mean they should.

Taking all the elements of Sarbanes-Oxley together – and with the view that laws and regulations should at least do no harm – I would say the jury is still out on whether the overall impact of the Act has been beneficial, at least until we see the effect of the new and improved Section 404 management guidance and AS5.

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[1] http://www.sec.gov/about/whatwedo.shtml.

[2] http://dms.osec.doc.gov/cgi-bin/doit.cgi?204:112:b5cb1e0524515cab300f742827cfbffb674ce49b3a4e11d278495fcc3c38fff0:245

[3] http://www.sec.gov/news/speech/2006/spch050806cag.htm.

[4] Federal Register, Vol. 71, No. 248, Wednesday, December 27, 2006, pp. 77635-77653 (http://www.sec.gov/rules/proposed/2006/33-8762fr.pdf).